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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No.

CITY CHEVROLET COMPANY, *Petitioner*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioner, City Chevrolet Company, respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered in the above entitled cause on January 11th, 1956.

OPINIONS BELOW

The opinion of the Court of Appeals (Appendix "A", infra, pp. 20a-21a) has not yet been officially reported. The Memorandum Findings of Fact and Opinion of the Tax Court (Appendix "A", infra, pp. 1a-19a) is not officially reported.

JURISDICTION

This case involves deficiency in income tax and originated in the Tax Court by the filing of a petition for review pursuant to Section 272(a)(1) of the Internal Revenue Code (26 USC 272). The judgment of the Court of Appeals was entered on January 11th, 1956, (App. A, infra). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

The Court of Appeals for the Fourth Circuit affirmed, per curiam, a decision of the Tax Court denying the petitioner a full deduction in 1946 for bonuses paid its officers for the year 1946 in accordance with bonus contracts initiated years prior thereto when all voting stock of the corporation was owned by "strangers".

The questions are:

1. Whether the decisions of the Courts below were contrary to law in determining that a change in the stock ownership of a corporation vitiates its compensation contracts with its employees, for federal tax purposes.

2. Whether the decisions of the Courts below were contrary to law in disregarding the testimony of qualified and experienced witnesses when the respondent offered no witnesses or evidence to justify disallowance of the portion of the compensation which he asserted to be unreasonable.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the Internal Revenue Code and of the Regulations promulgated thereunder are set forth in Appendix B, infra.

STATEMENT

City Chevrolet Company, the petitioner, is a North Carolina Corporation with its principal place of business in Charlotte, North Carolina. Since the date of its incorporation in January, 1935, it has sold and repaired new and used motor vehicles, supplies, parts and accessories and has acquired and operated facilities for such purposes.[1]

General Motors Holding Corporation[2] invested its money ($27,000.00) in the Class A voting stock and P. Abernethy invested his ($3,000.00) in the Class B non-voting stock of petitioner.

Petitioner hired Abernethy as its President and Operator and agreed to pay him a salary and bonus. General Motors also gave him an option to buy its Class A stock out of dividends and bonus. Under the plan Abernethy bought A stock and had to convert it to B stock. Not until all of the A stock had been converted and eliminated did the B stock acquire voting privileges. Abernethy bought out General Motors in March 1941. (Appendix A, infra, pp. 4a-6a)

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[1] References are either to selected portions of the Tax Court record printed in the Appendix in petitioner's brief in the Court below, or to those undisputed findings of fact contained in the Tax Court's Memorandum Findings of Facts and Opinion contained in Appendix A hereof.

[2] General Motors Holding Corporation was the dealership investment subsidiary of General Motors Corporation, formed to enable men of ability and promise to assume management of dealerships and eventually to acquire full ownership. It was dissolved in 1938 and its functions carried on in a division of General Motors Corporation designated Motors Holding Division, referred thereafter in this petition as General Motors.

From 1935 through 1946, petitioner paid its managing officers pursuant to written contingent bonus agreements.

On April 30th, 1935, petitioner's directors (two of whom were General Motors nominees) approved a bonus agreement between petitioner and Abernethy. The pertinent paragraphs are

> "3. The Dealer Company agrees to pay the operator, as its President, in addition to his salary, a bonus equivalent to 50% of its net earnings commencing January 22, 1935, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> "4. Net earnings as used in the foregoing paragraph shall mean the net profits of the Dealer Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits." (Appendix A, infra, p. 6a)

The bonus was computed after the deduction of income taxes.

Needing help to run the company Abernethy in 1937 by agreement of a few months duration and then again in 1939 to induce E. R. McHenry to rejoin the company, agreed, in a personal contract between them, to pay a bonus to McHenry for his services amounting to one-half of the bonus to be received by Abernethy from the Company and for McHenry to own one-half of the stock purchased in the name of Abernethy from General Motors. (Appendix A, infra, p. 10a) Abernethy held this stock in trust for McHenry since it

was registered in his, Abernethy's name. The final transfer from General Motors to Abernethy was made on March 11th, 1941, and thereafter on March 19, 1941, Abernethy transferred 1/2 of his stockholding, 275 Class B shares, to McHenry and one share to his wife, Violet M. Abernethy. (Appendix A, infra, p. 7a)

In order to continue their bonus agreement entered into when General Motors controlled petitioner (the split of the 50 per cent of net profits etc.) Abernethy, McHenry and Mrs. Abernethy, the Directors, approved contracts between each, thus formalizing the arrangement with petitioner.[3] This contractual arrangement did not increase the potential bonus that could be paid each. It did not enlarge the burden nor immediately produce more compensation for them. It merely carried on the division of the 50 per cent bonus. In short their control of the company did not cause them to change their contingent compensation plan in order to procure more money for themselves.

The pertinent portions of the contracts are as follows:

> "3. The Dealer Company agrees to pay the Operator, as its President, in addition to his salary, a bonus equivalent to 25% of its net earnings commencing January 1st, 1941, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> "4. Net earnings as used in the foregoing paragraph shall mean the net profits of the Dealer

[3] It should be noted that the contracts are identical with the contracts between Abernethy and petitioner supra with only the date changed and the 50 per cent provision reduced to 25 per cent in each.

> Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits." (Appendix A, infra, p. 7a)

The bonus was also computed after deduction of income taxes.

Respondent arbitrarily disallowed the entire bonus of $4,527.67 paid to each officer, Abernethy and McHenry in 1945 and limited each of them to their $10,000.00 basic salary.

Respondent also arbitrarily disallowed the entire bonus of $30,881.69 paid to each in 1946 and limited each of them to their $12,000.00 basic salary.

Petitioner sought a redetermination by the Tax Court of the deficiencies assessed. The cause was heard before the Honorable C. Rogers Arundell on September 28, 1953, at Greensboro, North Carolina. Certain facts were stipulated. Other facts were developed through six witnesses called by petitioner. No witnesses were called by Respondent.

Obviously recognizing the bonus agreement results for the year 1945, the Tax Court allowed all of the bonuses computed and paid for that year. (Appendix A, infra, p. 19a)

Not so for the year 1946 however! Though high in its praise of both Abernethy and McHenry[4] the Court

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[4] "We think the record makes it clear that both Abernethy and McHenry were executives of superior ability and broad experience in the automobile business and that petitioner was fully justified in paying each of them in 1946 more than the $12,000 basic salary respondent determined as reasonable compensation

allowed a flat amount of $50,000.00 as total compensation for both, $25,000.00 for each officer, drawing no distinction between salary and bonus, with no regard for the contractual obligation of petitioner. (Petitioner had paid each man $42,881.69—salary of $12,000.00 and bonus of $30,881.69.)

The Tax Court in its opinion relied upon and cited only one case, and said as follows:

> "We had occasion to consider the effect of such a bonus plan in University Chevrolet Co., 16 T.C. 1452, affd. 199 F. 2d 629, and there decided that once the ownership of the corporation's stock has passed to the officers receiving the bonus, the fact that the compensation was paid in strict accordance with the agreement is in no sense determinative of the question of its reasonableness. The reasonableness of the compensation paid to Abernethy and McHenry must be determined on the basis of all of the facts." (Appendix A, infra, p. 17a)

Petitioner appealed to the Court below from that part of the decision involving 1946. The United States Court of Appeals for the Fourth Circuit in a per curiam decision, affirming the Tax Court's opinion, accepted the Tax Court's doctrine announced in *University Chevrolet Co., supra,* as follows:

> "A bonus contract which was reasonable as holding out an incentive to those managing the corpoation when its stock was owned by others could

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for each officer. The figure fixed by respondent was even less than the salary paid to Abernethy and McHenry in 1941 when each received approximately $18,000. The excellent and intelligent job done by these men in the period between 1941 and 1946 in promoting and expanding the business was quite outstanding." (Appendix A, infra, pp. 17a-18a)

well be held unreasonable when the managers themselves became owners of the stock and the question was not what incentive was needed to call forth their best efforts, but what part of the earnings of the corporation could fairly be paid to them for their services as officers. See University Chevrolet Co. v. Com'r, 16 T.C. 1452, aff. 199 F. 2d 627." (Appendix A, infra, p. 21a)[5]

REASONS FOR GRANTING THE WRIT

The decision under review urgently requires judicial correction.

The confusion which exists in the federal tax field of reasonable compensation is so great that no one can be reasonably certain that any contingent compensation contract will be recognized for tax purposes.

1. THE CONTINGENT COMPENSATION CONTRACTS. Although the respondent has established tests for these contracts in his regulations (Appendix B, infra), in this and many cases, these legal tests have become meaningless.

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[5] In the University Chevrolet case, the Tax Court's opinion states:

> "General Motors furnished the original capital, but under the plan, if successful, it would recoup that capital and meanwhile receive dividends. It could well afford to allow a large part of the earnings to go to the manager as a salary bonus in order to obtain a man who would build up a profitable business at the location and buy the stock of the corporation, all at no ultimate cost but with great benefit to General Motors. However, it does not follow that such a contract would be entered into at arm's length under different circumstances. The circumstances differed vitally once Davis became sole owner of the petitioner corporation.
>
> For a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense".

So, today, the taxpayers find themselves in a situation (similar to that recently concerned with the family partnership confusion finally clarified by this Court in *Commissioner* v. *Culbertson*, 337 U.S. 722 (1949)). They are the victims of the application of incorrect legal tests to the facts and suffer since correct legal tests are disregarded by the respondent, the Tax Court and the Circuit Courts.

Petitioner in this case has been subject to such treatment. Respondent disallowed all compensation paid under contingent compensation arrangements negotiated at "arms length" years before the taxable year in question.

The Tax Court, relying on *University Chevrolet Co. Inc., supra,* having concluded that the bonus agreement "is in no sense determinative of the question of its (compensation) reasonableness" continued its opinion without further mention of the contractual bonus agreements and without giving any weight whatsoever to their existence.

The United States Court of Appeals for the Fourth Circuit, also relying on *University Chevrolet Co. Inc., supra,* affirmed the Tax Court and adopted the erroneous position that a contingent compensation contract can be reasonable at its inception and for years thereafter but becomes unreasonable by change in stock ownership. (Appendix A, infra, p. 21a)

The contingent compensation arrangement initiated with Abernethy in 1935 was unquestionably General Motors' agreed purchase price to obtain the services of Abernethy within the wording of the respondent's regulation

> ". . . if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid".
>
> (Reg. 111, Sec. 29.23(a)-6(2), Appendix B, infra)

Likewise, the contingent compensation arrangement commenced in 1937 between McHenry and Abernethy was, as testified to by both men, an absolute condition precedent to McHenry accepting employment (R. 20a, 27a) So on March 10, 1941 the situation was:

> (a) Strangers owned 100% of the voting stock;
>
> (b) Each of the operators, Abernethy and McHenry, were receiving, in addition to minimum salaries, contingent compensation in an amount equal to 25% of the profits after deductions previously mentioned.

As of March 10th, 1941, the Courts below would allow the entire compensation received by these men as reasonable (*University Chevrolet Co., infra;* T. C. Opinion, Appendix A, infra, p. 17a; CA-4 Decision, Appendix A, infra, p. 21a).

As of March 11th, when General Motors relinquished its control the respondent, the Tax Court and the Courts of the Fourth and Fifth Circuits hold that the contingent compensation contracts cease to be a factor in determining reasonableness.

The Sixth Circuit would not so hold. *Mayson Manufacturing Co.* v. *Commission,* 178 F. 2d 115.

The Tax Court in *University Chevrolet, supra,* even went to a further extreme in stating "For a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense."

Petitioner, as a Corporation just as was University Chevrolet, is unable to comprehend that it lost its corporate entity for tax purposes when its voting stock changed ownership on March 11th, or that it was relieved of its contractual obligation to pay the bonuses.

Abernethy and McHenry continued to render the same valuable services to petitioner. Contingent compensation contracts do not depend upon stockholdings to produce revenue.

The doctrine of *University Chevrolet, supra,* is wrong—it is bad law—it discriminates against those employees who have free bargain employment contracts with corporation. When they subsequently obtain the controlling stock it destroys the contractual relationship.

According to the Court's reasoning in *University,* as applied in this case:

(a) A contingent compensation contract between a corporation and its President so that he can use the compensation to acquire ownership of the corporation, results in "reasonable compensation".

This erroneous test simply stated is "that how the employee spends his money rather than did

he earn it" determines whether the compensation is reasonable.

(b) That same contingent compensation arrangement becomes "nonsense" after the officer obtains control of the corporation even though he continues to furnish the same or more valuable services to the corporation.

This conclusion is indirectly based on the false premise that the corporate entity is to be disregarded as to existing compensation plans as of the date the stock control changes hands.

If Abernethy and McHenry had in each year in question used their authority as controlling stockholders and directors to vote themselves the bonuses paid, the Commissioner would have a point. But no such procedure was followed. The contracts which produced the bonuses were continued in 1941. They were not altered or amended but faithfully carried out without change. If in the years in question, Abernethy had owned all of the stock, McHenry's bonus would have been as great as it was, and the same as Abernethy's, and vice versa.

The compensation paid under the contingent contract between petitioner and Abernethy and McHenry was not, by any stretch of the imagination determined by their stockholdings.

If General Motors had retained its interest, they would have received the same amount. If either Abernethy or McHenry had remained alone, he would have received double the amount. The stock ownership did not bring on the increased earnings. Their ability to take as much as they pleased did not enlarge their

earnings. The stock control they had over the corporation did not increase their bonus compensation. Admittedly, each could have received 50 per cent of the profits from General Motors. Both had worked under such contracts previously and both testified that they would not have remained in the company's employ if they had not received this bonus agreement.

In fact in their dealings with each other, all the aspects of arms-length transactions are evident, McHenry came and went several times and each time exacted a bonus as payment for his services in developing the company. And Abernethy on his part, used the bonus to bring him back and secure his valuable services for petitioner.

Certainly one can hardly claim that either took advantage of petitioner by forcing a bonus agreement under the then prevailing conditions and circumstances of world, national and local unrest and uncertainty, at a rate well below that which other companies would have paid them. *Cp. Austin et al.* v. *U. S.*, 28 F. 2d 677 (CA5-1928). They are at least entitled to payment at a rate they would have paid others or others would have worked for, or others would have paid each of them.

One's stockholdings should not bar equal treatment for oneself with strangers, when such a plan is reasonable and has been so stated to be by uncontroverted testimony.

The very contingent nature of the bonus provides for liberal compensation in good years and less compensation in the less profitable years. It was held in *Austin* v. *U. S., supra,* that the fact that "in the actual working out of the contract contingent compensation

may prove to be greater than the amount which ordinarily would be paid" was no ground for the denial of part of the deduction. See *Thomas N. Perkins et al.* v. *Commissioner,* 33 BTA 606, 623—(1935); *Howard Sole, Inc.,* para. 53,076 P-H Memo. T.C., Docket No. 34082 (1953); *Robert Rogers, Inc.* v. *United States,* 93 F. Supp. 1014 (Ct. Cls. 1950).

This Court in *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115 (1930) has held that compensation paid in a current year for services performed in earlier years is deductible in the current year providing the amount currently paid when added to what has already been paid for the earlier years is not unreasonable.

That case did not involve contingent compensation but it is of import here since by their very nature, contingent compensation contracts provide no compensation in years of no profits when, nevertheless, efforts and services might be maximum.

University Chevrolet Co. Inc., supra, while apparently approving an incentive bonus for buy-out purposes denies such approval when control of the company passes to the employee. This decision and what is more alarming, its application, is definitely in conflict with the Court of Appeals for the Sixth Circuit. In *Mayson Manufacturing Co.* v. *Commissioner,* 178 Fed. 2nd 115 (CA6-1949), the Court considered the Tax Court's failure to give due weight to the bonus contract substantial error. The compensation plan disregarded by the Tax Court was established in July 31, 1929 at a time when the beneficiaries of the plan were not controlling stockholders. Subsequently, the controlling stockholder died (April 6, 1939) and his stock was redistributed among the surviving stock-

holders, who continued as employees and paid themselves out of the bonus fund established.

The Commissioner challenged the payments to the then controlling stockholders in 1943, a war economy year. The Court reversed the Tax Court, holding that the arm's length contract of long standing should have been considered.

We commend this decision to this Court for its analysis and application to the facts in the case at bar. The Fourth Circuit apparently did not appreciate the similarity and seems to have been misled by the buy-out provisions of Abernethy's and McHenry's contracts with petitioner. Petitioner maintains that cannot govern.

2. THE COMMISSIONER OFFERS NO EVIDENCE. Another important principle is involved in this case concerning which there exists a definite conflict between several United States Courts of Appeal.

The Sixth Circuit holds that the taxpayer's claimed amount of reasonable compensation cannot be reduced by the Courts if qualified witnesses testify to the reasonableness of the salary, and the Commissioner does not supply evidence to the contrary. *Roth Office Equipment Co.* v. *Gallagher,* 172 F. 2d 452 (CA-6, 1949); *Wright-Bernet, Inc.* v. *Commissioner,* 172 F. 2d 343 (CA-6, 1949); *Mayson Mfg. Co.* v. *Commissioner,* 178 F.2d 115 (CA-6, 1949); *The Loesch & Green Construction Co.* v. *Commissioner* (C.A. 6, No. 11932, March 2, 1954), citing prior cases par. 72,411 P-H Fed. 1954.

The Fifth Circuit, in a 1950 case, applied the above principle in *J. H. Robinson Truck Lines, Inc.* v. *Commissioner,* 183 F. 2d 7 (CA-5, 1950). Then after tem-

porarily changing this position in a 1951 case, the Court in 1953 said:

> "Since the Commissioner offered no evidence, the petitioner was denied the opportunity of examining the correctness of his computations and was left to stand upon its own proof, none of which was refuted. Therefore, we think the burden of presenting evidence to rebut any presumption in favor of the Commissioner's findings was fully met, and the Tax Court clearly erred in finding that the salaries were unreasonable." *R. P. Farnsworth & Co. Inc.* v. *Commissioner,* 203 F.2d 490 (CA-5, 1953)

This pronouncement of the law by the Fifth Circuit is likewise the law established by other Federal Courts of Appeal:

See:

> *A & A Tool & Supply Co.* v. *Commissioner,* 182 F. 2d 300, 39 A.F.T.R. 517 (C.A. 10, 1950)
> *Heywood Boot & Shoe Company* v. *Commissioner,* 76 F. 2d 586. (C.A. 1, 1935)

Other Circuit Courts have taken a contrary view. *R. H. Oswald Co., Inc.* v. *Commissioner,* 185 F.2d 6 (C.A. 7th); *Anchor Co.* v. *Commissioner,* 42 F. 2d 99 (C.A. 4th); *Builders Steel Co.* v. *Commissioner,* 197 F.2d 263 (C.A. 8th).

Petitioner does not question the right of the Courts below to draw inferences and to weigh the evidence.

However, when the respondent can arbitrarily disallow a deduction and then not be required to defend his position in Court, an unfair burden is placed upon the taxpayer. As stated in *Mayson Mfg. Co., supra,* "No opportunity was afforded petitioner to

cross examine any witness who might have testified for the respondent to the contrary or to test the correctness or fairness of the figures selected by the respondent and the Tax Court."

As a result the judges of the Courts below do not receive all necessary evidence in the cases to reach a logical conclusion.

MERTENS LAW OF FEDERAL TAXATION, Sec. 50.71 in discussing questions of evidence states, in effect that the presumption that respondent's assessment of the tax is prima facie correct merely means that, in the absence of evidence to the contrary, respondent's assessment will be sustained, but when there is contrary evidence, this presumption vanishes. The presumption is not evidence itself—it only shifts the burden of going forward with the proof.

In this case respondent produced no witnesses, offered no testimony and introduced no evidence to contradict the unimpeached and uncontradicted testimony of the qualified, impartial witnesses who testified that in their opinion the compensation paid to Abernethy and to McHenry for the year 1946 was reasonable.

Likewise, respondent offered no evidence or testimony that the compensation paid was unreasonable for any reason.

Neither the Tax Court nor the Fourth Circuit required the respondent to justify his determination. Thus this case unhappily follows the pattern of compensation cases with an arbitrary disallowance by respondent, followed by a Tax Court or District Court hearing in which the respondent offers no evidence and a decision establishing an allowable amount greater

than the Commissioner's but less than the taxpayer had claimed. RESEARCH INSTITUTE OF AMERICA, FEDERAL TAX COORDINATOR, Sec. H-2104, pp. 26,111, 26,351-26,368.

CONCLUSION

We have presented to this Court for its consideration, serious conflicts that exist in the Courts below—conflicts that can be reconciled by this Court only. No other court has the authority or ability to do so.

Unless the law is clarified the tax burden will continue to fall unfairly upon taxpayers who must present their cases before unsympathetic tribunals. Accident of residence will govern.

Wherefore, this petitioner prays this Court that a writ of certiorari be granted.

Respectfully submitted,

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April 1956

APPENDIX

APPENDIX A

T. C. Memo. 1954-1955

THE TAX COURT OF THE UNITED STATES

Docket No. 36280

Filed September 20, 1954

CITY CHEVROLET COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Amounts deductible by petitioner corporation in 1945 and 1946 as reasonable compensation of its president and vice-president determined on the facts.

Frederic D. Dassori, Esq., and *Dee R. Bramwell, Esq.*, for the petitioner.

James R. Harper, Jr., Esq., for the respondent.

Memorandum Findings of Fact and Opinion

Respondent determined deficiencies against petitioner as follows:

Year	*Income Tax*	*Declared Value Excess Profits Tax*	*Excess Profits Tax*
1945		$398.39	$8,788.73
1946	$23,093.22		

The sole issue for decision is the correctness of respondent's action in disallowing, as excessive compensation,

bonuses paid by petitioner to its president and vice-president totaling $9,055.34 in 1945 and $61,763.38 in 1946.

Other matters covered by the deficiency notice have been conceded by petitioner and will be given effect under Rule 50.

FINDING OF FACT

City Chevrolet Company, petitioner herein, is a North Carolina corporation doing business in Charlotte, North Carolina. Its corporation income and declared value excess profits tax return for the calendar year 1945 and its corporation income tax return for the calendar year 1946 were filed with the collector of internal revenue for the district of North Carolina.

In 1935 it was the policy of General Motors Corporation to select men of ability and promise to assume the management of its dealer operations and eventually to acquire full ownership. In implementing that plan, General Motors was willing to provide a large percentage of the initial capital investment in order to enable the selected executives to get started with limited amounts of cash. General Motors was anxious in early 1935 to strengthen one of its dealerships at Charlotte, North Carolina, which up to that time had been under-capitalized and generally unsuccessful. In accordance with its plan, it sought to obtain the services of P. L. Abernethy.

Abernethy received his first experience in the automobile business as a bookkeeper for Burrell-Walker Company where he worked for three years commencing in 1919. He left that company to work for three years as a salesman in a grocery business at Newton, South Carolina. Abernethy then returned to the automobile business in Charlotte as a bookkeeper for Carolina Cadillac Company where he worked until October 15, 1928, at which time he obtained employment with the Chevrolet Dort Division of General Motors in Charlotte and later in Atlanta. In Charlotte he

was the office manager and car distributor for North Carolina and South Carolina until 1934 when he was promoted to the job of regional car distributor in Atlanta, Georgia. His responsibilities covered the Chevrolet operations in the States of North and South Carolina, Georgia, Alabama, Florida, and parts of Tennessee and Kentucky. A part of each month during this period was spent in the main office of Chevrolet in Detroit where, along with nine other regional car distributors, he helped formulate schedules for the various plants throughout the country.

Petitioner was incorporated on January 22, 1935. The initial investment of General Motors was $27,000 and Abernethy invested $3,000.

Among the purposes for which the corporation was formed were the following, as set forth in the articles of incorporation:

(1) To purchase, rent, manufacture, deal in, sell, operate and let for hire, automobiles, motor cycles, and motor vehicles and supplies and fittings therefor of every kind and nature.

(2) To erect, purchase, lease or otherwise acquire and to maintain and operate filling stations and garages for the sale of gasoline, oils and other automobile supplies, and the storing, caring for and repairing of automobiles and motor vehicles of every kind, nature and description.

(3) To make and sell parts, supplies, batteries and accessories connected with the use of motor cars and vehicles; to store, clean and repair automobiles and motor vehicles and to replace their parts, and to do all other things incidental to the business of conducting a dealership for the sale of new and used automobiles, garages, repair shops, or other businesses profitable in connection therewith.

Petitioner received a franchise from Chevrolet authorizing it to sell and service Chevrolet passenger and commercial vehicles under which it operated from 1935 throughout the years in question.

Petitioner's authorized capital stock upon incorporation was $99,600 consisting of 2,768 shares, of which 608 shares were designated Class A common stock, having a par value of $75 a share, and 2,160 shares of Class B common stock, having a par value of $25 a share.

On January 22, 1935, General Motors subscribed for 320 Class A voting shares and 118 Class B shares of petitioner's stock, two nominees of General Motors subscribed for one Class B share each, and P. L. Abernethy subscribed for 120 Class B shares.

The holders of Class A stock issued and outstanding had all voting rights, had equal participation with Class B stock in dividends, had an option to convert one or more shares of Class A stock for an equal number of shares of Class B stock and, in the event of liquidation, had the prior right to receive up to $85 per share before participation in the net assets by the Class B stock.

The holders of any Class B stock issued and outstanding were to obtain voting rights only when no shares of Class A stock were issued and outstanding; had equal participation with Class A stock in dividends and, in the event of liquidation after the net assets had been distributed up to $85 per share to holders of Class A stock, had the right to receive up to $85 per share of the remaining net assets and to participate equally with Class A stock in any net assets then remaining.

Subsequent amendments to the certificate of incorporation resulted in fixing the authorized capital stock of the corporation at $97,000, consisting of 970 shares of $100 par value each, of which 470 shares were Class A and 500 shares were Class B.

Pursuant to amendment of the certificate of incorporation on April 29, 1935, the stockholders surrendered their original certificates and new certificates were issued on April 30, 1935, as follows:

General Motors	270	Class A
Herbert M. Gould (General Motor's nominee)	1	Class A
J. A. Ayers (General Motor's nominee)	1	Class A
P. L. Abernethy	30	Class B

On April 30, 1935, General Motors subscribed to an additional 58 shares of Class A stock and on May 30, 1936, it purchased an additional 90 shares of Class A stock.

On January 22, 1935, at the meeting of the incorporators, Abernethy and the two nominees of General Motors were elected as the directors of the corporation. The board of directors, during the entire period from January 22, 1935 to March 19, 1941, consisted of three members one of whom was Abernethy, the other two being at all times nominees of General Motors.

The powers of the directors and shareholders, as set forth in the certificate of incorporation, included the following:

(4) Any and all of the directors of the corporation may be removed at any time with or without cause by the owners and holders of a majority of the issued and outstanding voting stock of the corporation.

(5) The Board of Directors are expressly authorized to remove at any time with or without cause any officer of the corporation elected by them.

(6) When, in the judgment of a majority of the Board of Directors, it is deemed advisable, the Directors, upon vote or written consent of two-thirds in interest of all the Stockholders, shall have the right at their election to dissolve the corporation and sell its assets, wind up its business affairs, and distribute its

assets and the proceeds thereof among its Stockholders as they may severally be entitled to receive the same as aforesaid.

On January 22, 1935, at the first meeting of the directors of the corporation, Abernethy was elected president, his salary being fixed at $350 per month. On April 30, 1935, the directors authorized a bonus agreement between the corporation and Abernethy. The paragraphs of that agreement here pertinent provided as follows:

> 3. The Dealer Company agrees to pay the Operator, as its President, in addition to his salary, a bonus equivalent to 50% of its net earnings commencing January 22, 1935, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> 4. Net Earnings as used in the foregoing paragraph shall mean the net profits of the Dealer Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits.

The bonus was computed after the deduction of income taxes.

In 1935 Abernethy had an agreement with General Motors to acquire the voting stock out of dividends and 50 per cent of his bonus. There was no fixed period during which the stock had to be acquired. Commencing with June 5, 1936, Abernethy purchased Class A shares from General Motors from time to time and had them converted to Class B shares. The final transfer to Abernethy was made on March 11, 1941, and thereafter General Motors held no stock interest in petitioner. After March 11, 1941, there was no Class A stock outstanding and the exclusive

voting rights were held by the Class B stockholders. On March 19, 1941, P. L. Abernethy transferred 275 Class B shares to E. R. McHenry. On the same date, Abernethy transferred one share to his wife, Violet M. Abernethy. After these transfers, Abernethy held 274 Class B shares.

On March 19, 1941, at a special meeting of the directors, the General Motors nominees resigned as directors and E. R. McHenry and Violet Abernethy were elected as their successors. E. R. McHenry was also elected vice-president. Abernethy continued as a director and the board has remained unchanged through the years in question.

At the special meeting on March 19, 1941, the board of directors authorized and adopted a Bonus Agreement between P. L. Abernethy and the corporation. The paragraphs of that Agreement here pertinent provide as follows:

> 3. The Dealer Company agrees to pay the Operator, as its President, in addition to his salary, a bonus equivalent to 25% of its net earnings commencing January 1st, 1941, for the balance of the calendar year (and thereafter from calendar year to calendar year) in excess of 15% on its average month-end invested capital during said year or period.
>
> 4. Net Earnings as used in the foregoing paragraph shall mean the net profits of the Dealer Company before deducting the bonus expense herein provided for. The accounting and reserve policies and procedures adopted from time to time by the Dealer Company shall be used as the base for determining said net earnings and profits.

At the same meeting, a bonus agreement was entered into between the corporation and McHenry which in all material respects was identical with the Abernethy agreement.

On June 8, 1944, the stockholdings in the corporation were altered by gifts to the respective wives of the stock-

holders so that on and after that date, including the years 1945 and 1946, the stock ownership was as follows:

Name	*No. Class B Shares*
P. L. Abernethy	145
E. R. McHenry	140
Violet Abernethy	130
Lettie S. McHenry	135

Gift tax returns were filed by Abernethy and McHenry covering the gifts to their respective wives.

The premises on South Tryon Street in Charlotte occupied by the former dealer were in very bad condition when Abernethy commenced business as president and operator of City Chevrolet Company. The equipment was useless and the building had to be renovated throughout. The personnel organization, consisting of only about 18 people, was very poor. Abernethy customarily spent 12 to 18 hours a day re-vamping the whole organization. He personally supervised the entire operation, including the office, the parts department, the service department, and the used car reconditioning department. Street repairs completely blocked off the main entrance in 1935 from May or June until September, the only available entrance being through a narrow back street. This tended to handicap operations and kept used cars covered with dust. At that time, Abernethy established bank credit and obtained financial aid from the American Trust Company in Charlotte, which credit has been maintained and expanded since that time.

In November 1935 petitioner first hired McHenry as new car sales manager. McHenry had been highly recommended by the zone manager, T. D. Hunter. McHenry's major experience in the automobile industry began in 1914 as a field employee of the Ford Motor Company. In 1921, with two partners, he operated his first dealership, selling Fords in Owensboro, Kentucky. He continued to operate at Owensboro until 1923, at which time he and his two partners ob-

tained another Ford dealership in Bowling Green, Kentucky. McHenry personally supervised the Bowling Green Company while the other two partners ran the Owensboro dealership. In July 1926 both businesses were sold and each partner made about $100,000.

McHenry returned to the automobile business during the years 1928 to 1932, with his former partners, as the Chevrolet dealer operating the McHenry-Stark Motor Company in Evansville, Indiana. Starting in the fall of 1933, he operated the McHenry Chevrolet Company in Indianapolis until May 1935. His contract with General Motors at that time provided for a bonus of 50 per cent of the profits after 15 per cent had been set aside. When he left Indiana, many dealers there were losing money and he came to North Carolina in search of a dealership in that section of the country.

Petitioner made a net profit of $1,054.96 in 1935. In 1936 Abernethy changed service managers, added to the parts personnel and strengthened the used car reconditioning department by removing it from the general repair shop to a leased building across the street. The organization developed with McHenry handling sales to the extent that the company made a net profit of $16,743.47 in 1936.

In 1937, the company made a net profit of $17,315.06. In June 1937 McHenry resigned as new car sales manager to become the Chevrolet dealer in Wilson, North Carolina, and Abernethy continued to run petitioner alone.

In 1938, the company made a net profit of only $948.26. McHenry had rejoined the company at Abernethy's request in December 1937 but left again to reduce expenses in May 1938 when the company lost $8,541.38 during the first four months of the year. The poor conditions resulted from an over-supply of 1937 models in the area at the time the 1938 model was announced. The over-supply was due largely to an out-of-state dealer's dumping 150 new 1937 models on the market through a Charlotte used car dealer.

It took petitioner from November 1937 to March 1938 to sell its 1937 models at a substantial loss.

In 1939, the company made a net profit of $21,906.74. Nineteen thirty-nine was a heavy production year requiring the wholesaling of used cars at a loss. The profit per vehicle was as low as $25 to $30.

McHenry rejoined the company in 1939 on a permanent basis. The company hired him as vice-president and Abernethy agreed to pay him 50 per cent of his bonus and to allow McHenry to buy one-half of the stock of City Chevrolet as he acquired it from General Motors. From that time, Abernethy held 50 per cent of the stock he owned in trust for McHenry.

In 1940, the company made a net profit of $25,817.41, even though it was a heavy production year and the used car market was poor. The company opened a separate truck service in 1940 in the building which had been rented for used car reconditioning.

After McHenry rejoined petitioner in 1939, he had charge of sales and personnel and consulted with Abernethy on all operations. He and Abernethy together worked out the program for each department and one of them would present it to the department. Their responsibilities were essentially co-extensive although Abernethy looked after most of the financial part of the business and the factory contacts.

The year 1941 was a heavy production year. Used cars were sold at a heavy loss. Some new cars had to be sold for $25 to $30 gross profit. Competition included another Chevrolet dealer, three Plymouth dealers, and two Ford dealers in Charlotte. In addition, there were located on the perimeter operating at low overhead another Chevrolet dealer and two additional Ford dealers. This tended to make petitioner dependent upon volume operation.

In 1941, the Government ordered a freeze on automobile production. At the end of the year, petitioner had a heavy inventory of 167 new cars and 40 used cars. Most dealers had heavy inventories at the time and were in a dilemma as to which way to turn. Abernethy and McHenry felt that the way to survival would be to have new models to sell and they took every unit the factory would deliver. Abernethy searched for additional cars, buying some from other dealers. As a result, by March 1942 petitioner had 242 new cars in various warehouses and storage areas.

In 1941, petitioner's retail credit line with General Motors Acceptance Corporation was $600,000 as compared with $50,000 in 1935.

Abernethy and McHenry started a training program for mechanics in 1941 and developed their service department each year following. During the years of no new car production, petitioner's survival depended primarily upon service operations and sale of parts and accessories. During those years, both Abernethy and McHenry spent 12 to 18 hours a day at work and conferred on policy matters and post-war planning for several hours on Sunday afternoons.

In 1942, Abernethy was appointed chairman of the local unit of the Office of Defense Transportation.

Abernethy and McHenry planned petitioner's post-war building expansion program and completed important profit-making portions of the plan in 1946. They obtained for petitioner certain unimproved realty on January 8, 1946, for $16,000 and constructed the truck service building after obtaining a loan of $50,000 from the American Trust Company. In addition, they negotiated the purchase of another property for $30,000 on October 30, 1946, for future construction in 1947 of the paint and body shop building. They also negotiated for and purchased for $10,000 the parcel of property previously leased in 1945 for construction of the parts warehouse building.

Parts and accessories sales were increased by having a wholesale man solicit new business in the vicinity of Charlotte by calling on garages, fleet users and other dealers.

In 1945, in anticipation of expanding sales, Abernethy and McHenry hired a new car sales manager "in training" at a salary of $350 per month, plus one per cent of new car sales. He had limited responsibility and nothing to do with policy making.

During 1945, 10 or 15 used car dealers entered business in Charlotte, raising the total to 25 or more. This competition continued through 1946.

On September 1, 1945, effective that date, the corporation restored Abernethy's and McHenry's salaries to $1,000 per month, eliminating the previous cuts of 1942.

In the early part of 1946, a General Motors strike of 112 days caused cessation of new car and truck deliveries. The company kept operating on its parts and service business which had increased from covering approximately 70 per cent of fixed expenses to covering about 120 per cent of fixed expenses.

Abernethy and McHenry adopted the policy of not requiring a trade-in in order to obtain a new car. They received only 72 or 73 trade-ins against more than 600 new units sold. Although petitoner was able to sell all cars it could obtain in 1945 and 1946, it was the policy of Abernethy and McHenry to sell only to those who deserved them and in no case did they require the purchaser to buy accessories which he did not want. These policies tended to build up the good will of petitioner.

To prepare for keen competition anticipated in the future, Abernethy and McHenry began to train a complete new sales organization and to increase and improve personnel training procedures.

In 1946, Abernethy was elected president of the North Carolina Automobile Dealers Association.

During 1935 through 1946, petitioner sold the following number of new and used cars and trucks:

Year	*New*	*Used*	*Total*
1935	340	503	843
1936	673	1,204	1,877
1937	681	1,168	1,849
1938	392	872	1,264
1939	587	1,061	1,648
1940	886	1,590	2,476
1941	972	1,727	2,649
1942	153	313	466
1943	122	49	171
1944	34	13	47
1945	82	14	96
1946	660	78	738

During 1935 through 1946, an analysis of gross sales and profit for each department of petitioner shows the following:

	New Car Department		Used Car Department	
Year	*Gross Sales*	*Gross Profit*	*Gross Sales*	*Gross Profit*
1935	$236,823.29	$ 48,327.42	$118,279.90	$ (5,679.49)
1936	493,003.01	110,943.33	264,429.14	(12,660.18)
1937	520,310.99	120,925.09	287,974.16	(16,348.32)
1938	315,821.67	71,474.28	225,408.10	(20,624.59)
1939	474,684.03	118,562.73	278,273.74	(23,110.11)
1940	722,931.15	172,883.58	426,310.72	(45,666.54)
1941	874,737.70	228,853.84	515,740.00	(55,439.09)
1942	154,596.60	44,305.26	101,997.94	5,707.16
1943	143,581.12	50,809.50	33,107.81	4,104.20
1944	50,455.78	12,547.84	7,153.24	807.27
1945	124,760.20	34,123.42	12,138.61	1,162.40
1946	820,251.73	188,395.61	51,963.12	5,510.89

Year	Service Department Gross Sales	Service Department Gross Profit	Parts & Accessories Department Gross Sales	Parts & Accessories Department Gross Profit
1935	$ 33,699.77	$17,300.72	$ 29,803.34	$ 7,128.94
1936	56,536.05	27,713.86	51,977.22	11,498.81
1937	70,645.55	33,729.56	66,827.16	15,579.85
1938	57,264.44	28,716.80	59,413.01	14,256.64
1939	62,982.30	30,737.58	68,057.35	15,929.07
1940	974.54	173.65		
	85,363.01	41,793.51	85,042.95	19,689.47
1941	16,175.73	3,151.40		
	100,362.96	48,933.64	114,863.38	28,356.05
1942	68,450.53	35,182.22	91,722.67	23,103.84
1943	85,549.62	42,955.16	89,051.35	24,483.40
1944	97,927.92	50,026.70	125,398.74	33,123.88
1945	127,589.24	61,564.09	191,051.54	64,886.62
1946	191,853.34	79,816.27	250,754.50	105,380.10

Year	Total All Departments Gross Sales	Total All Departments Gross Profit
1935	$ 416,606.30	$ 67,078.09
1936	865,945.42	137,495.82
1937	945,757.86	153,886.18
1938	657,907.22	93,823.13
1939	883,997.42	142,119.27
1940	1,320,622.37	188,823.67
1941	1,621,880.27	249,855.84
1942	416,767.74	108,298.48
1943	351,289.90	122,352.26
1944	280,935.68	96,505.69
1945	455,539.59	161,736.53
1946	1,414,822.69	379,103.37

The salary paid to Abernethy from 1935 and the bonus paid in accordance with the bonus agreements were as follows:

Year	*Salary*	*Bonus*	*Total*
1935	$ 3,966.67	—	$ 3,966.67
1936	4,600.00	$ 5,237.36	9,837.36
1937	6,250.00	4,656.80	10,906.80
1938	5,549.43	—	5,549.43
1939	5,708.38	6,828.37	12,536.75
1940	6,000.00	8,783.69	14,783.69
1941	10,250.00	7,667.52	17,917.52
1942	9,000.00	771.34	9,771.34
1943	9,000.00	3,308.34	12,308.34
1944	9,000.00	823.50	9,823.50
1945	10,000.00	4,527.67	14,527.67
1946	12,000.00	30,881.69	42,881.69

The salary paid to McHenry from the year 1941 and the bonus paid under the terms of the bonus agreement were as follows:

Year	*Salary*	*Bonus*	*Total*
1941	$10,250.00	$ 7,667.52	$17,917.52
1942	9,000.00	771.34	9,771.34
1943	9,000.00	3,308.34	12,308.34
1944	9,000.00	823.50	9,823.50
1945	10,000.00	4,527.67	14,527.67
1946	12,000.00	30,881.69	42,881.69

Dividends were declared and paid in the amounts and years indicated and distributed to the shareholders in proportion to their holdings as follows:

Year	*Amount*
1935	—
1936	$11,813.87
1937	13,326.50
1938	—
1939	14,179.00
1940	16,186.50
1941	27,549.50
1942	—
1943	17,600.00
1944	3,300.00
1945	11,000.00
1946	—
1947	—
1948	—
1949	22,000.00
1950	44,000.00

The average number of employees of petitioner during the years 1935 through 1946 was as follows:

Year	*Employees*
1935	35
1936	56
1937	67
1938	50
1939	53
1940	63
1941	76
1942	50
1943	37
1944	40
1945	47
1946	68

In September 1951 all of the stock of City Chevrolet Company theretofore owned by Abernethy and McHenry

was sold by them in an arm's length transaction to disinterested parties.

The total compensation paid to Abernethy and McHenry for the year 1945 was a reasonable allowance for personal services rendered.

Total reasonable compensation for the services of Abernethy and McHenry for 1946 was $50,000.

The facts stipulated by the parties are incorporated herein by this reference.

OPINION

ARUNDELL, *Judge:* Respondent has limited the deductions for compensation of the company's president and vice-president to the amounts paid in the form of salaries and disallowed entirely the additional amounts paid them under the terms of a bonus plan. The bonus plan was originally installed at a time when General Motors or one of its subsidiaries held all of the voting stock, and the plan was a vital feature in a General Motors campaign to strengthen its Chevrolet dealerships during the mid-1930's. The plan was continued after Abernethy and McHenry acquired all the stock of petitioner.

We had occasion to consider the effect of such a bonus plan in *University Chevrolet Co.*, 16 T.C. 1452, affd. 199 F. 2d 629, and there decided that once the ownership of the corporation's stock has passed to the officers receiving the bonus, the fact that the compensation was paid in strict accordance with the agreement is in no sense determinative of the question of its reasonableness. The reasonableness of the compensation paid to Abernethy and McHenry must be determined on the basis of all of the facts.

We think the record makes it clear that both Abernethy and McHenry were executives of superior ability and broad experience in the automobile business and that petitioner was fully justified in paying each of them in 1946 more

than the $12,000 basic salary respondent determined as reasonable compensation for each officer. The figure fixed by respondent was even less than the salary paid to Abernethy and McHenry in 1941 when each received approximately $18,000. The excellent and intelligent job done by these men in the period between 1941 and 1946 in promoting and expanding the business was quite outstanding. In 1946 the two executives were well along on an expansion program involving the expenditure of some $300,000, requiring important decisions on their part and as much as 18 hours a day on the job.

We are equally convinced, however, that some part of the total of $85,763.38 paid by the corporation in 1946 to its two top executives must be disallowed as excessive. The large increase in 1946 profits on which the bonuses are based, while due partly to the efforts of Abernethy and McHenry, were just as clearly caused by the general economic conditions at that time. Production of automobiles during the war years 1942 through 1945 was negligible, resulting in an excess of demand over supply in 1946. Under such circumstances, it was not too difficult to sell whatever new cars could be obtained.

We cannot believe such large bonuses would have been paid to officers who were not stockholders at a time when the needs of the business were such as to make impracticable the payment of a dividend. It is true that testimony was offered that the compensation of Abernethy and McHenry was reasonable, but we learned of no instance where the bonuses reached the sums paid in this case, and we note with interest that the manager hired by Abernethy in his new dealership since leaving petitioner, was limited to a bonus of $20,000 regardless of how high the profits might go. In the instant case we have the managerial duties divided between two officers and regard must be had to the total compensation paid for such services.

After carefully weighing the many factors bearing on the question, we have decided that $50,000 would be reason-

able compensation for the services of Abernethy and McHenry for 1946, or $25,000 for each officer, and that to the extent the deduction exceeded that figure, it was properly disallowed by respondent.

As to the year 1945, we think the total of $29,055.34 paid by petitioner to Abernethy and McHenry was reasonable and that respondent was in error in disallowing any part of that amount.

Decision will be entered under Rule 50.

(Tr. 21)

THE TAX COURT OF THE UNITED STATES

Washington

Docket No. 36280

CITY CHEVROLET COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

DECISION

Pursuant to the Memorandum Findings of Fact and Opinion of the Court filed September 20, 1954, the respondent herein, on November 12, 1954, filed a recomputation for entry of decision, the petitioner's acquiescence in the respondent's recomputation being noted thereon. Wherefore, it is

ORDERED AND DECIDED: That there is no deficiency in declared value excess profits tax for the taxable year 1945, and that there are deficiencies in excess profits tax and income tax for the taxable years 1945 and 1946 in the amounts of $1,387.04 and $13,213.22, respectively.

(Signed) C. R. ARUNDELL
Judge

Entered Nov. 23, 1954

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7023.

CITY CHEVROLET COMPANY, *Petitioner,*

versus

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ON PETITION TO REVIEW THE DECISION OF THE TAX COURT OF THE UNITED STATES.

(Argued January 6, 1956. Decided January 11, 1956.)

Before PARKER, Chief Judge, and SOPER and DOBIE, Circuit Judges.

Frederic D. Dassori (Dee R. Bramwell on brief) for Petitioner, and C. Guy Tadlock, Attorney, Department of Justice, (H. Brian Holland, Assistant Attorney General, Robert N. Anderson and A. F. Prescott, Attorneys, Department of Justice, on brief) for Respondent.

PER CURIAM:

This is a petition to review a decision of the Tax Court relating to deductions for the year 1946 on account of personal services rendered taxpayer corporation by officers who with their wives were its sole stockholders. The facts are fully stated in the opinion of the Tax Court and need not be repeated here. Taxpayer contends that the bonus of $30,881.69 paid to each of the officers for the year 1946 in addition to salaries of $12,000 each was reasonable because provided for by a contract under which the officers were to

have 50% of the net profits of the corporation in excess of 15% and that this was in effect a continuation of a contract made sometime prior thereto when the stock of the corporation was owned by others. The question is one of fact and we are not prepared to hold that the holding of the Tax Court with regard thereto was clearly wrong. A bonus contract which was reasonable as holding out an incentive to those managing the corporation when its stock was owned by others could well be held unreasonable when the managers themselves became owners of the stock and the question was, not what incentive was needed to call forth their best efforts, but what part of the earnings of the corporation could fairly be paid to them for their services as officers. See *University Chevrolet Co.* v. *Com'r* 16 T. C. 1452, aff. 199 F. 2d 627.

Affirmed.

APPENDIX B

Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered . . ."

Regulation 111:

"Sec. 29.23(a)-6. Compensation for Personal Services.—Among the ordinary and necessary expenses

paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

"(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. • • •

"(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

"(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like

enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

"Sec. 29.23(a)-7. Treatment of Excessive Compensation.—The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. • • • In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient and subjected to both normal tax and surtax."

"Sec. 29.23(a)-8. Bonuses to Employees.—Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for services actually rendered by the employees provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income."

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 846

CITY CHEVROLET COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet 1a–19a) are not reported. The opinion of the Court of Appeals (Pet. 20a–21a) is reported at 228 F. 2d 894.

JURISDICTION

The judgment of the Court of Appeals was entered on January 11, 1956. The petition for a writ of certiorari was filed on April 10, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Whether the amount taxpayer-corporation claimed as a deduction for salaries paid to its two-officer stockholders exceeded a reasonable allowance for personal services actually rendered.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 23 (a).)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.23 (a)–6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation

payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

STATEMENT

The Tax Court's findings (Pet. 2a–17a), which the Court of Appeals held to be fully supported

by the evidence (Pet. 20a–21a), may be summarized briefly as follows:

In 1935, General Motors Corporation, investing $27,000, organized the taxpayer and installed P. L. Abernethy, who invested $3,000, as its president. General Motors retained control but provided for Abernethy's gradual assumption of ownership through the purchase of voting stock out of a bonus to be paid to him. The bonus was to be 50 percent of the net profit in excess of 15% of the average month-end invested capital. Taxpayer obtained a franchise from the Chevrolet Division of General Motors and Abernethy, who had extensive experience in the automobile business, was elected a director and president. (Pet. 2a–6a.)

On March 19, 1941, Abernethy, having completed his purchase of non-voting stock and its transfer to voting stock, took control of taxpayer and transferred one-half of the stock to E. R. McHenry and one share to his wife Violet M. Abernethy. At a meeting of the board of directors on that day McHenry and Violet Abernethy were elected to the board and McHenry was elected vice-president. At the same meeting a new bonus agreement was authorized and adopted which provided for the payment to each Abernethy and to McHenry of a bonus of 25 percent of the net profits. (Pet. 6a–7a.) Later in 1944, after gifts of stock to the wives of Abernethy and

McHenry, the stock ownership was as follows (Pet. 8a):

Name	*No. Class B Shares*
P. L. Abernethy	145
E. R. McHenry	140
Violet Abernethy	130
Lettie S. McHenry	135

McHenry, who also had considerable experience in the automobile business, first joined taxpayer in 1935 as new car sales manager. He left in June of 1937, returned in December of that year, and left again in May of 1938. Abernethy rehired McHenry in 1939 as vice-president and agreed to pay him 50 percent of his bonus and to allow him to buy one-half of the stock as Abernethy acquired it from General Motors. Abernethy held the stock in trust for McHenry until 1941. (Pet. 8a–10a.)

Beginning in 1939, McHenry was in charge of sales and personnel and consulted with Abernethy on all operations. Prior to that time, Abernethy had customarily spent 12 to 18 hours a day renovating and rebuilding the agency and revamping the whole organization. After 1939, Abernethy and McHenry developed programs for each department of the business. Abernethy looked after the financial aspects of the business and maintained factory controls. (Pet. 8a, 10a.)

During 1940 and 1941, there was heavy production of automobiles. In 1940, taxpayer opened a truck service department. In the latter part of 1941 there was a Government freeze on new pro-

duction. Near the end of this year, taxpayer and other dealers had heavy inventories of new cars. Abernethy and McHenry felt that the best way to survive the situation was to have as many new models as possible and they took every unit the factory would deliver. They also bought new cars from other dealers and by March of 1942 taxpayer had 242 models in various storage facilities. (Pet. 10a–11a.)

At the beginning of the post-war period in 1946, under new and improved training procedures, a new sales force was organized. However, there was no difficulty in selling all cars that could be obtained in that year. (Pet. 12a.)

Taxpayer paid dividends in eight of its first eleven years of existence but paid no dividends in 1946, 1947, and 1948. (Pet. 16a.)

Taxpayer paid Abernethy and McHenry salaries of $12,000 each in 1946, plus bonuses of $30,881.69, or a total of $85,763.38. (Pet. 15a.) The Commissioner disallowed the bonuses. (Pet. 17a–18a.)

On the evidence before it, the Tax Court found that $50,000 (*i. e.*, $25,000 for each officer) was reasonable compensation for the services of Abernethy and McHenry for the year 1946 (Pet. 17a). The Court of Appeals affirmed this finding.

ARGUMENT

Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, *supra*, p. 2, allows a tax-

payer to deduct from income ordinary and necessary expenses of conducting a business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered * * *." Section 29.23(a)-6 of Treasury Regulations 111, *supra*, pp. 2–3, states the test of deductibility to be whether the compensation payments are reasonable and "in fact payments purely for services."

The single issue in this case concerns the amount which taxpayer corporation should be allowed to deduct as reasonable compensation for the services of its two officer-stockholders. Challenging the concurrent findings of the Tax Court and the Court of Appeals, taxpayer contends (1) that the courts below ignored relevant evidence (Pet. 9), and (2) that the Commissioner failed to establish the unreasonableness of the amount claimed as salary deductions (Pet. 17). These contentions are insubstantial and the asserted conflicts do not exist.

1. Taxpayer's contention (Pet. 8–15) that in reaching their conclusion as to reasonable compensation the courts below ignored the bonus agreement is refuted by the record. The Tax Court gave full recognition to the agreement when it held that the total compensation paid in 1945, which included $4,527.67 as a bonus to each officer, was reasonable. It was only when the amount paid under the bonus formula reached an extravagant level in 1946 that the court found

it could no longer accept the "bonus" label. The amount finally determined to be reasonable for 1946, the year in issue, included $13,000 as a bonus in addition to a salary allowance for each officer. (Pet. 15a, 19a.)

The Commissioner has recognized bonus agreements in his Regulations as approved by the Secretary of the Treasury (Sec. 29.23(a)-6(1), *supra,* p. 3), but has prescribed that "[i]n any event the allowance for compensation paid may not exceed what is reasonable under all the circumstances."

Taxpayer argues (Pet. 9) that the Court of Appeals for the Fifth Circuit has followed an erroneous view with regard to bonus agreements as shown by its decision in the case of *University Chevrolet Co.* v. *Commissioner,* 199 F. 2d 629. This is not borne out by a reading of that opinion. Judge Holmes speaking for the court observed (p. 630):

> Bonuses to employees will constitute allowable deductions * * * provided such payments, when added to stipulated salaries, do not exceed a reasonable compensation for the services rendered.

Contrary to taxpayer's assertion (Pet. 11), there is no conflict as between the position taken in the instant case or in the *University Chevrolet* case and the position of the Sixth Circuit in *Mayson Mfg.* v. *Commisioner,* 178 F. 2d 115. There, the court allowed the salary paid under the

bonus plan because it was not unreasonable. The Sixth Circuit was careful to point out that the question was one of fact and that several criteria should be considered in determining reasonableness.

Taxpayer's real contention is that bonus agreements are completely controlling and leave no room for consideration of the reasonableness of the compensation. This contention, however, does not square with the statute which permits deductions only of "reasonable allowance for salaries or other compensation for personal services actually rendered." (Sec. 23 (a) (1) (A).)

2. Taxpayer's contention (Pet. 17) that neither court below required the Commissioner to justify his determination overlooks the fact that the taxpayer seeking a deduction from income has the burden of establishing not only its right to the deduction, but also the amount of such deduction. *New Colonial Co.* v. *Helvering,* 292 U. S. 435.

Taxpayer asserts a conflict between the instant case and decisions of the First, Fifth, Sixth, and Tenth Circuits as to the effect of the Commissioner's failure to offer testimony on the reasonableness of the compensation in issue. (Pet. 15–17.) An examination of the decisions (Pet. 15, 16), however, reveals that each Court of Appeals recognized that the question presented was one of fact and that whether the compensation paid was reasonable depended upon the

particular circumstances shown.[1] In the instant case, the Tax Court had before it stipulations of fact and numerous exhibits. And it heard, both on direct and cross examination, the testimony of the six witnesses called by taxpayer. Obviously, it could consider the facts as to which they testified as well as their opinions or ultimate conclusions on the subject of reasonableness of compensation. As the detailed findings and the opinion of the Tax Court show (Pet. 1a–19a), the court considered and evaluated the prevailing economic conditions, the size and the complexities of the business, the salaries paid to persons in comparable positions, and the nature and extent of the services rendered. These are the criteria invariably applied in determining the reasonableness of compensation under any given set of facts. On the basis of its consideration of the record, the court allowed a deduction substantially in excess of the amount allowed by the Commissioner (for the year 1946, $50,000 as compared to $24,000). The court was scarcely obliged to accept, without any qualification, the ultimate conclusions reached by taxpayer's witnesses.

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[1] This proposition is, of course, well settled. See, *e. g.*, *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593 (C. A. 2d), certiorari denied, 311 U. S. 680; *San Marco Shop* v. *Commissioner*, 223 F. 2d 702 (C. A. 5th); *Al Haft Sport Enterprises* v. *Commissioner*, 189 F. 2d 384 (C. A. 6th).

CONCLUSION

The issue determined below was factual in nature and there is no conflict of decision as to whether the appropriate criteria were applied. There is no occasion for further review of the concurrent findings. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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